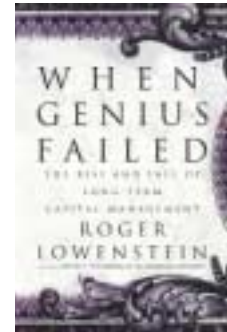
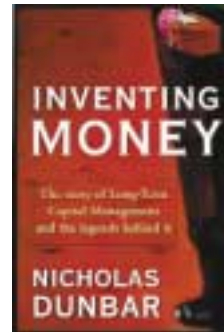


Inventing Money: The Story of Long-Term Capital Management and the Legends Behind It

Nicholas Dunbar
John Wiley & Sons, Ltd., 2000

When Genius Failed: The Rise and Fall of Long-Term Capital Management

Roger Lowenstein
Random House, 2000



In September 1998, a unique meeting was held at the New York offices of the Federal Reserve. Forty-five heads and senior officers of the largest U.S. banks—as well as Swiss, French, and British banks—had been summoned to discuss rescuing a hedge fund that was in a swoon.

After several days of negotiating, scheming, posturing, screaming, and arm-twisting, 14 of the banks agreed to put up \$3.65 billion to acquire a 90 percent equity stake in Long-Term Capital Management (LTCM). Although no government money was involved, the Fed was widely criticized on editorial pages and in Congress for the unprecedented bailout of the well-heeled investors of the fund.

Almost everything about LTCM was unprecedented. Founded in 1994 by John Meriwether and several other refugees from Salomon Brothers' near meltdown in the early 1990s, LTCM also included two Nobel Prize winners in economics (Merton and Scholes) and a former Federal Reserve vice chairman (David Mullins) as partners.

They started the business with \$1 billion of investor funds and a fee structure of 2 percent of assets and 25 percent of gains, rather than the 1 percent and 20 percent that had been standard in the hedge fund business for 40 years. In their first two years of operations the fund had produced returns of over 40 percent per year.

To get these spectacular returns, they had a two-part strategy they used over and over again. First, they found securities that should have similar prices that had diverged for some reason and they "bet" that those prices would converge. They called this "collecting nickels" be-

cause the gain was usually very small.

The second part of their strategy turned this into their 40 percent returns by leveraging through derivatives. (After all, Merton and Scholes had received their Nobel Prizes for inventing the formulas for pricing derivatives.) When things were going well, they operated at about 30 times leverage (i.e., investments equal to 30 times their capital).

At the beginning of 1998, after four years of 25 percent plus net returns, the partners of LTCM forced their investors to take back \$2.7 billion of capital, bringing themselves down to a \$5 billion cushion. Their assets totaled \$129 billion in addition to a notional \$1.25 trillion of derivative positions.

As you might guess from the numbers just quoted, they lost more than 90 percent of their capital in 1998 by the time of the bailout. The Fed decided to step in because it feared that many of the counterparties in the derivative contracts (mainly the banks called in to the "rescue") would have been ruined or severely damaged if LTCM defaulted.

In their own ways, the two books by Dunbar and Lowenstein bring this Greek tragedy to life. Dunbar, a financial writer in London, walks us through the history of derivatives from the time of the ancient Sumerians to the work by Black, Scholes, and Merton that led to their Nobel Prize. Dunbar then covers the story of the Salomon bond arbitrage group where Meriwether eventually became responsible for almost half of Salomon's total profits.

Long-Term Capital Management doesn't enter Dunbar's book until Page 125. When it does, Dunbar has already taught the reader the financial and historical ba-

sis for most of the major trades and positions that caused both the success and the failure of LTCM. In *Inventing Money*, the theory, the philosophy, and the trades are what led to the LTCM's downfall.

Lowenstein's *When Genius Failed*, on the other hand, tells the story of the personalities and egos. Meriwether is out to vindicate his ouster from Salomon. Merton and Scholes are looking for financial rewards commensurate with their intellectual contributions. They provide the assurances that it would take a "once-in-a-100-year" event to cause LTCM to lose even 25 percent of its capital.

The other partners are all gunslingers with ice water in their veins, out to make more and more spectacular trades and never blinking when their positions start to turn sour. In Lowenstein's story, the theories behind LTCM are flawed from the start. For example, he believes the evidence was clear in the stock market crash of 1987 that "continuous trading," one of the underpinning assumptions of the Merton and Scholes formulas, is not always the case, especially in a crisis.

No matter what your participation in the financial markets, this is an important story to learn from. Lessons include: the usual story that liquidity disappears when problems start; a financial strategy that works well in good times may be terrible in troubled times; financial history doesn't repeat itself so the past isn't a good guide to the future.

These and other truths about investing are graphically illustrated in the LTCM story. They apply equally to banks, insurance companies, and brokerages.

If you have the time, read both books.

—David Ingram